

An Overview of Small and Medium-Sized Banking Development in Bosnia and Herzegovina

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Abstract: *The purpose of this paper is to investigate the level of SME banking development in Bosnia and Herzegovina (BH). By using a structured questionnaire, the authors discuss perceptions of the banking sector representatives in BH regarding SME banking and their future plans for the management of credit risk associated with financing the SME sector. One of the main findings of this research is that the SME sector is becoming a strategic sector for BH banks and banks are willing to increase their involvement with SME clients. Authors also present results on current level of banks' exposure to SMEs, types of financial services offered to SME clients by BH banks, drivers of banks' involvement with SMEs, obstacles to further development of banks' involvement with SMEs. Based on the banks' responses and results of research conducted, suggestions to policy makers are given, such as tax reforms, interest rate subventions to SMEs, improvement of judiciary, simplifying administrative procedures. Also, some recommendations are given to banks, such as the need for better understanding the requirements of SME clients providing them more personal approach and creating a partnership, as well as lobbying the government bodies to change regulations governing SME sector.*

Keywords: *Financial System; Small and Medium-Sized Enterprises (SMES); SME Banking; Comparative Experiences; Bosnia and Herzegovina (BH)*

JEL Classification: *G21*

Article History

*Submitted: 11 August 2014
Resubmitted: 13 October 2014
Resubmitted: 9 November 2014
Resubmitted: 23 December 2014
Accepted: 20 January 2015*

<http://dx.doi.org/10.14706/JECOS S11519>

Introduction

Since SMEs are the primary moving mechanism of new job creation and increase of gross domestic product, their growth and development are the priority amongst the goals of national economies for developed countries of the world as well as for countries in transition. On the other hand, financial system plays an important role in achieving these goals with the main purpose of preserving the stability of national economy. For the last few years, the main focus of the financial system (mostly, banking sector) towards the real sector has been expanding. From the position of being observed by the financial institutions as too complex for risk management, the SME sector became the strategic goal for the institutions around the world.

Furthermore, in the aftermath of the global financial crisis, SMEs are facing many challenges and limitations in their business operations. Reduced accesses to market, reduced managers' ability to managing resources as well as limited access to capital are marked as the most important challenges for SMEs to overcome. Growth of SME banking, in terms of crediting and providing a wide range of banking services to SMEs, is the result of the fact that banks, besides understanding the needs of SMEs, are managing to find the answers to challenges of high credit risk. Due to the information technology development, the banking sector is increasing its support for development and growth of SMEs through the increase of financial support and also through the consulting services as a response to the challenges faced by this sector.

The aim of this paper is to point out the importance of SME banking, as a contributor to bank profitability, in developed part of the world as well as in developing countries. Moreover, the objective is to investigate the level of SME banking development in BH. The BH banking system is consisted of Central bank, two banking agencies and 27 banks. Central Bank of BH maintains monetary stability by issuing domestic currency, convertible mark, according to the currency board arrangement. Banking agencies, as authorities for bank supervision and licensing, are established on entity level as Banking Agency of the Federation of BH and Banking Agency of Republic of Srpska. According to latest data available, total assets of 27 BH banks at the end of June 2014 were BAM 23,607.4 million.

This paper is divided into three parts. The first part of the paper discusses the phenomena of SME segment "bancarization", focusing on the motives for a greater involvement of banks in financing SMEs in the developed part of the world. In the second part of the paper a brief review of recent literature on SME banking is given.

In the third part of the paper the results of the empirical study on SME banking development in BH are presented. By using a structured questionnaire, a discussion is given of the perceptions of the banking sector in BH towards its orientation to the SME sector and future plans for their support as well as for the management of credit risk associated with financing the SME sector.

The Theoretical Framework of the Phenomena of SME Segment “Bancarization”

The phenomena of SME segment “bancarization” is a syntagm used by de la Torre et al. (2009) to describe increased involvement of banks in financing SMEs as a strategic sector that in the last decade increased banks’ returns all over the world.

Growing interest of banks in the SME sector lies in the fact that entrepreneurs and SMEs represent the most efficient segment of the economy in most of the countries in the world. These enterprises have the highest contribution to the increase in employment, gross domestic product (GDP), and trade, which makes them the basis of national economies growth and development. Their role is especially important in transitional and developing countries facing problems of high unemployment, low degree of economic activity, inadequate competitiveness, and lack of investment. As a stable source of new job creation, SMEs have an important social function to absorb labor surplus in transition processes.

Importance of SMEs in the world economy was also observed by financial institutions. In that respect, many of the banking institutions recognized the SME sector as a strategic sector for increasing banks’ profit margins (Beck et al., 2009; de la Torre et al., 2009). According to the European Commission’s (EC) *SMEs’ Access to Finance survey* for 2013, the most common provider of loans to EU SMEs were banks, providing the loan to 85 per cent of all SMEs that borrowed in the last two years, where the most common amount (36 per cent of all loans) was €100,000 to €1 million, but just over half (52 per cent) borrowed less than €100,000 (EC, 2013). In addition, de la Torre et al. (2010) find that, in order to serve SMEs, banks are developing new business models, technologies, and risk management systems to provide a holistic approach to SMEs through a wide range of products and services, with fee-based products rising in importance.

SME banking per se is an “industry in transition”. From a market that was considered too difficult to serve, it has now become a strategic target of banks

worldwide. SME banking appears to be growing fastest in emerging markets (low- and middle-income countries) where this gap has been the widest. More and more emerging market banks are developing strategies and creating SME units.

In the International Finance Corporation's SME Banking Knowledge Guide it is indicated that importance of SME sector has been recognized by the governments around the world. In that respect, governments are more involved in creating positive environment for development of SME banking by addressing issues of legal and regulatory barriers, creating credit infrastructure, etc. Furthermore, in the same guide it is indicated that banks better understanding of SMEs needs and tailored approach to overcoming credit risk associated with SMEs can be observed as the most important factor of SME banking growth. New approach in creating tailored financial products/services for SMEs is shown to be beneficial for banks in terms of increase in their returns on assets from operations with SMEs

Literature Review on SME Banking Development

Development of commercial banking is related to the need of corporations for debt financing (loans) mostly in the USA. But during the 1990s, major regulatory changes impacted lending patterns of the US banks, changing the focus of the US banks from lending to large corporations to small businesses, which was the turning point for SME banking in the USA and, at the same time, for the rest of the world.

Analyzing transformation of the US banking industry in the light of many major regulatory changes that occurred in the period from 1974 to 1994, Berger et al. (1995) found that the major change in lending patterns of the US banks was related to a significant decline in lending to large business borrowers due to the increase of different (cheaper) types of financing in the growing the US debt market. Furthermore, Berger and Udell (1995) as well as Strahan and Weston (1998) observed that due to the bank consolidation under the Riegle-Neal Act of 1994, large banks decreased their involvement with SMEs, while an important role remained for community based banks in extending loans to small businesses. Later on, Berger and Udell (2002) and Vera and Onji (2010) found that bank consolidation in the USA did not affect small-business lending. Moreover, they found that large banks seem to be more actively involved in lending to small businesses. According to the survey of the US Small Business Administration (SBA, 2013), the value of small business loans outstanding to the value of total business loans outstanding for depository lenders in 2012 was 67.32 per cent.

Early research of the European banking system was conducted by Vitols (1998), who focused on German banks. This research showed that SMEs within German manufacturing sector, which accounted for almost 60 per cent of manufacturing employment, had the highest demand for long term debt capital. Analyzing debt account of SMEs and large companies, Vitols found that long-term bank debt accounted for 18.5 per cent of the balance sheet liabilities of small companies as opposed to 4 per cent for large companies, showing a strong market for SME loans.

In the early 2000s several researches discussed the demand side of SME lending (Schiffer and Weder, 2001; IADB, 2004; Beck, Demirgüç-Kunt and Maksimovic, 2005; Beck, Demirgüç-Kunt, Laeven and Maksimovic, 2006), while no comprehensive research existed on the supply side of bank financing to SMEs across countries.

The first worldwide comprehensive study on SME banking was conducted by Beck, Demirgüç-Kunt and MartínezPería (2008). The intention of this survey was to investigate bank financing to SMEs around the world, focusing on three main areas: banks' perception of the SME segment, drivers and obstacles to SME financing, and banks' perception of the role of government programs to support SME finance and of banking prudential regulations. Beck et al. (2008) found significant differences in exposure, lending practices, business models, as well as drivers and obstacles of SME finance for banks operating in developed *vis-à-vis* developing countries. The differences between developed and developing countries are likely to reflect deficiencies in the contractual and informational frameworks in developing countries and less stable macroeconomic environment.

Motivated by the previously mentioned survey, de La Torre et al. (2009, 2010) conducted a similar research amongst Argentinean and Chilean banks, analyzing drivers and obstacles to banking SMEs. In developing banking sectors of Argentina and Chile, banks began targeting SMEs due to the significant competition in the corporate and retail sectors. This research showed that banks limited the range of products they offer to SMEs to cope with macroeconomic and contractual risk, which is observed in emerging economies. De la Torre et al. also learnt that banks discovered a key, untapped segment and were making substantial investments to develop the relation with SMEs and compete for them. Additionally, the research showed that banks were developing the internal structures and mechanisms to work with SMEs, adapting their business and risk models to reduce the costs and risks of

the segment. As a part of this process, banks still need to obtain better measures of their exposure to the segment, in terms of income, costs or risk.

Several studies on SME banking development, focusing on transition economies in Europe, showed that, in case of Poland, there are noticeable patterns of change in how the banks regard the SME sector through changes in policies and strategies of commercial banks for increased interaction with medium-sized firms. This clearly indicates that there are specific responses in the commercial banking sector to the specific circumstances of transition (Feakins, 2004). On the other hand, in case of Croatia, commercial banks lack consistency in the loan approval criteria; hence, the low loan approval rate was likely a consequence of credit rationing due to lack of loan assessment skills amongst loan officers and might be a sign of high risk aversion or lack of relevant business and market research data needed for evaluation of the SME business projects (Czirák et al., 2005).

The SME Banking in Bosnia and Herzegovina: Current Position and Development Perspectives

The Methodology and Research Data

In order to assess the current position and development perspectives on BH banking sector involvement with SMEs, a questionnaire consisting of 16 questions was created. The questionnaire was designed to address three broad areas. The first area refers to measuring the extent of banks' involvement with SMEs; the second area refers to analyzing the determinants and driving forces of the degree of banks' financing to SMEs, such as demand factors, competition, corporate strategy, and macroeconomic, regulatory, and institutional factors; and the last one refers to investigating obstacles to banks' future involvement with the SMEs sector, focusing on understanding the government role in enhancing overall economic environment to strengthen the relation between the banking and SME sectors.

The questionnaire was sent to 23 banks in BH. The data presented in this paper were calculated based on the sample of 10 banks (i.e. 37 per cent of all BH banks), which returned the filled questionnaire. Each of them has SMEs amongst their clients.

To classify SMEs, all surveyed banks use average annual sales. However, a variety of ranges is noticeable, indicating that there is not a unified criterion to define the segment as a whole. For 40 per cent of the banks, a company is considered to be a

small enterprise (SE) when its average annual sales are below BAM 2 million. Average annual sales of BAM 3 million or less classify a company as an SE in 20 per cent of the banks. For 10 per cent of the banks this limit is BAM 5 million, while the same percentage of banks consider a company with average annual sales of under BAM 300,000 as an SE. One fifth of the banks do not classify SE and medium enterprise (ME) as different segments at all, defining them as a unique SME segment of clients, with the average annual sales limits of BAM 3 million and BAM 5 million. The lower limit of average annual sales for ME ranges from BAM 300,000 to BAM 5 million, while the upper limit ranges from BAM 3 million to BAM 100 million.

Besides average annual sales, 30 per cent of the banks have other criteria to define the SME segment, such as branch, market position, and total credit exposure under BAM 500,000.

The Current Position of the BH Banks Involvement with the SME Sector

All the surveyed banks have SMEs amongst their clients, as well as entrepreneurs who are defined as enterprises or crafts, which do not operate for more than 3.5 years. The banks have different levels of exposure to the SME segment in terms of loans (Table 1). The ratio of SME loans to total loans varies from 5 per cent to 70 per cent, with the average of 23.3 per cent, while the ratio of SME loans to total corporate loans is higher: from 7 per cent to 85 per cent, with the average of 38 per cent.

Table 1: Banks' Exposure to the SME Segment in Terms of Loans

Ratio of SME loans to total loans	5,0 %	9,0 %	12,0 %	17,0 %	18,0 %	25,5 %	30,0 %	70,0 %
Ratio of SME loans to total corporate loans	7,0 %	20,0 %	20,0 %	31,0 %	40,0 %	50,0 %	50,7 %	85,0 %

Source: Authors research

When it comes to banks' exposure to entrepreneurs, 40 per cent of the banks did not have the data on such exposure. For the rest of them, the ratio of entrepreneurs loans to total loans varies from 0.5 to 15 per cent, with the average of 5.7 per cent, while the ratio of entrepreneurs loans to total corporate loans ranges from 0.9 to 13.58 per cent with the average of 8.1 per cent.

Banks' involvement with the SME sector is also analyzed through deposits (Table 2). The range of SME deposits to total deposits ratio is 2 to 55 per cent, and its average is 16.1 per cent. Besides that, SME deposits to total corporate deposits ratio varies from 4 to 50 per cent, with the average of 24.2 per cent.

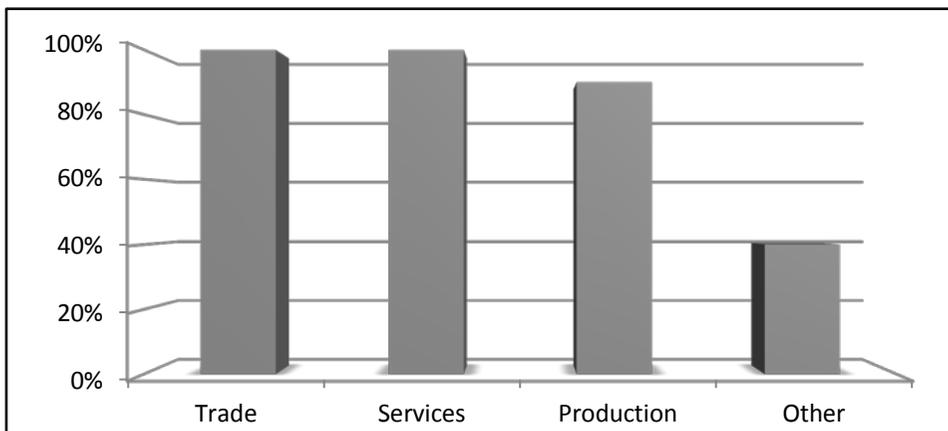
Table 2: Banks' Involvement with the SME Segment in Terms of Deposits

Ratio of SME deposits to total deposits	2,00 %	5,50 %	6,09 %	10,00 %	18,00 %	55,00 %
Ratio of SME deposits to total corporate deposits	4,00 %	12,47 %	14,00 %	20,00 %	45,00 %	50,00 %

Source: Authors research

Most of the SME clients come from the trade and services branches (Figure 1). Production is in the second place, with 90 per cent of the banks having SME clients from this branch. Also, 40 per cent of the banks pointed out that they have SME clients from other branches such as associations, information technologies, construction, agriculture, transport, real estate, mining, energy, and recycling.

Figure 1: Branches of Banks' SME Clients



Source: Authors research

In respect to maturity of loans offered to SME clients by the surveyed banks, most of the banks (60 per cent) categorize loans as short term, medium term, and long term, while the remaining 40 per cent of the banks do not make differences between medium term and long term, classifying all loans with over one year maturity as long term loans. The types of loans are presented in Table 3.

Table 3: Types of Loans to SME Clients

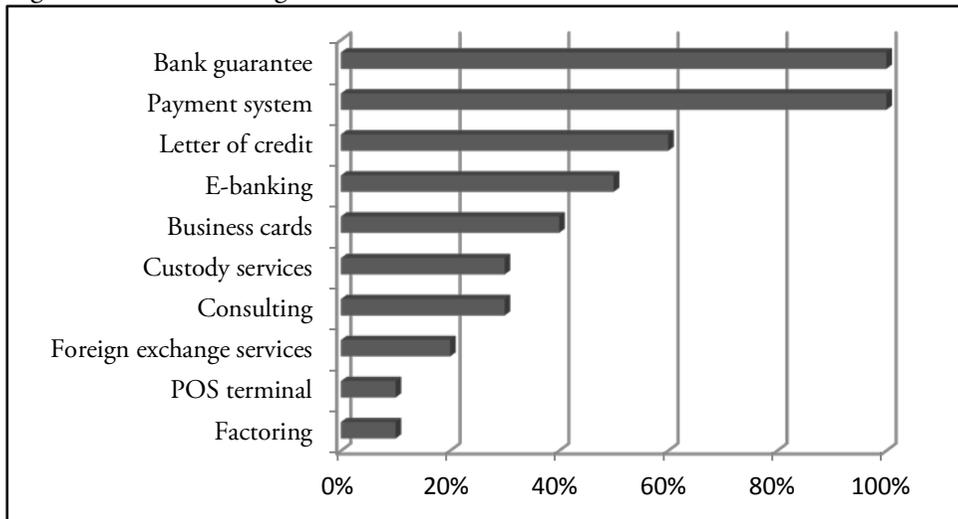
Loan maturity	Loan type
Short term	overdraft, amortizing loan, revolving loan, bullet loan, credit
Medium term	working capital loan, permanent working capital loan
Long term	investment loan, working capital loan, permanent working capital loan, fixed asset loan, consolidation loan, lombard loan, amortizing loan

Source: Authors research

Most of the surveyed banks (80 per cent) could not give a precise answer to the question about the average amount of loan given to SMEs, but they gave the information on ranges of SME loan amounts. The minimum amount of loan given to SMEs is BAM 1,000, while maximum is BAM 5 million. It is obvious that there is not a unified approach to SME lending and that banks have individual approaches to each SME, depending on client's needs, branch, creditworthiness, collateral, *etc.*

Regarding the products which banks use to engage with SMEs, besides primary deposit-credit activities, bank guarantees and payment system are mostly used by all the banks (Figure 2). Letter of credit is the next most used service (60 per cent of banks), followed by e-banking (50 per cent), and business cards (40 per cent of the banks). Custody and consulting services are offered to SMEs by 30 per cent of the surveyed banks, while the least used services for SMEs are foreign exchange services, POS terminals, and factoring.

Figure 2: Other Banking Products/Services for SME Clients

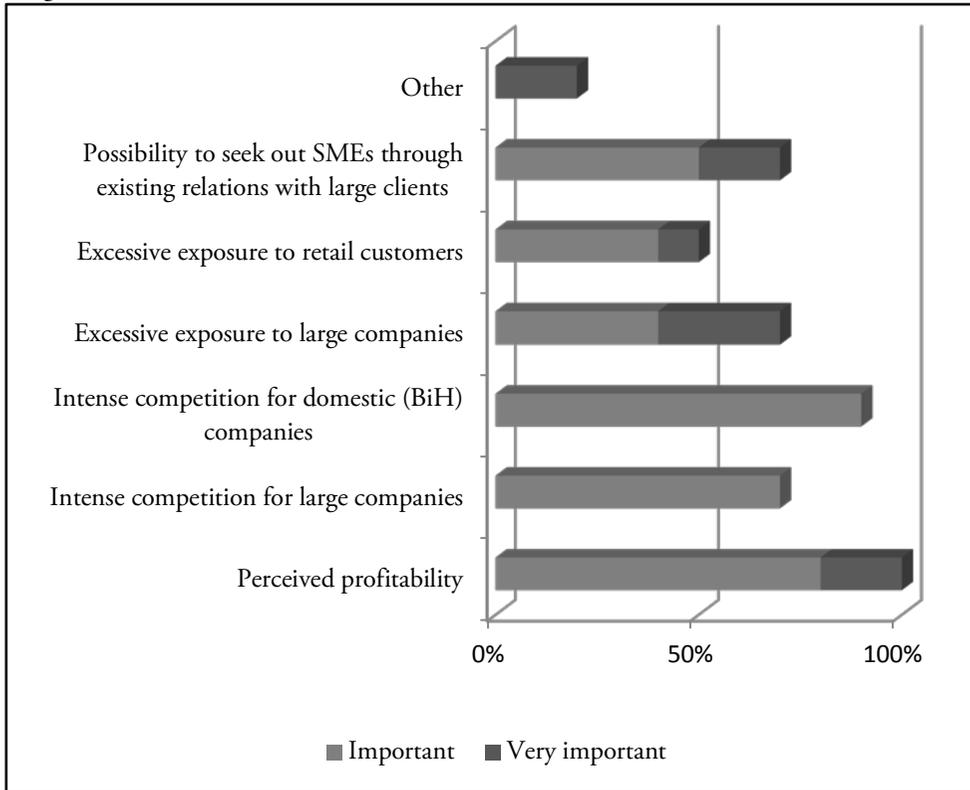


Source: Authors research

Banks usually require some collateral to grant loans to SMEs. The most commonly used collateral is mortgage. The second mostly used collateral is equipment and vehicle pledge, which is reported by 70 per cent of the banks. Furthermore, a high percentage of banks (60 per cent) use bills of exchange and deposits for collateral purpose. Also, important collateral is a co-borrower or a guarantee, while other collaterals such as insurance policies, securities, cession, protective clauses, payment orders, currency clauses, and precious metals are the least mentioned types of banks' protection from SMEs default.

Banks were asked to indicate the driving forces for SME lending and to explain how significant these factors are in defining their level of involvement with the segment. The options available to qualify the importance of these factors vary from not significant to extremely significant. Figure 3 shows the percentage of the surveyed banks that consider these factors to be significant or extremely significant drivers. The percentage of the banks that consider these factors not significant is not presented.

Figure 3: Drivers of Banks' Involvement with SMEs



Source: Authors research

A high level of perceived profitability of the SMEs segment is banks' main motivation for lending to SME clients, because banks expect high profits that will compensate for the higher risks of the segment. The possibility to seek out SMEs through existing relations with large clients was mentioned as a significant driver of banks' involvement with the segment. Many large companies' buyers and suppliers are SMEs, which are already assessed by large companies and characterized as suitable for business cooperation. Also, being in business relations with large companies makes SMEs business safer and more stable.

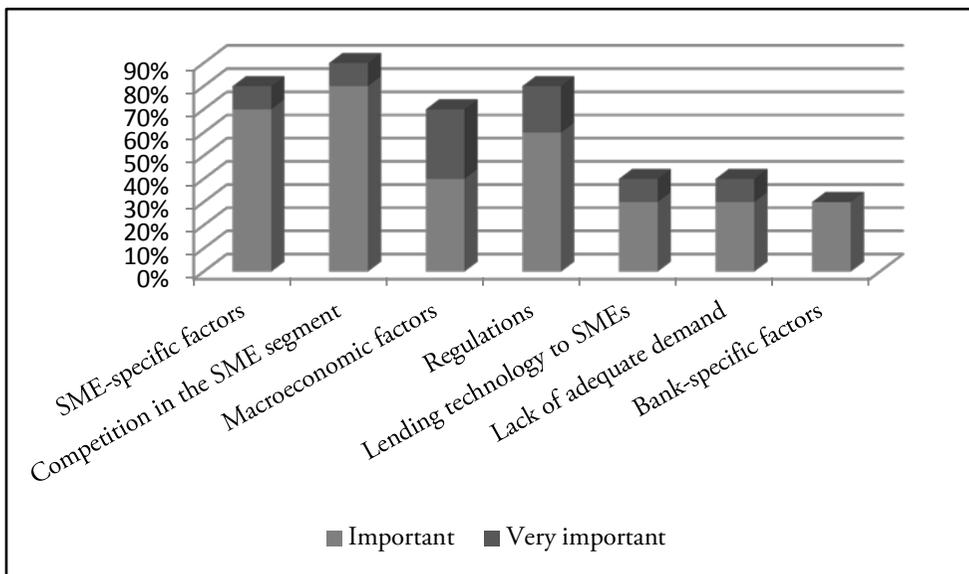
Another important motive is intense competition for domestic (BH) companies and for large companies, since high competition in these segments decreases bank profitability. According to banks' answers, participation in segments of large companies and retail customers has grown, causing excessive exposure to these

segments and therefore being a motive for turning to SME clients. Other driving forces, mentioned by 20 per cent of banks, are banks' strategic orientation to corporate sector, and therefore SMEs, as well as risk dispersion. All the banks surveyed stressed out the intention to increase their involvement with the SME sector in the future. Besides that, the banks which are subsidiaries of foreign banks and bank groups declared that their "parent" banks encourage SME financing.

Obstacles to Banks' Future Involvement with the SME Sector

After discussing the extent of BH banks' involvement with SMEs, as well as motives for such involvement, it is important to determine what obstacles banks face through financing SMEs. For this purpose, the banks were asked to indicate the obstacles to SME lending and to explain how significant these obstacles are in their level of involvement with the segment. The options available to qualify the importance of obstacles vary from not significant to extremely significant. Figure 4 shows the percentage of the banks that consider these factors to be significant or extremely significant obstacles. The percentage of the banks that consider these factors not significant is not presented.

Figure 4: Obstacles to Banks' Involvement with the SMEs



Source: Authors research

Competition amongst the banks in the SME segment is considered as the most important obstacle for SME financing. Therefore, the banks in BH have to compete for SMEs with all their resources in order to stay in the market and/or to increase market share. The second largest obstacle is regulation, with 20 per cent of the banks finding it very important and 60 per cent of banks finding it important. Further explanations by banks indicate that these regulations include not only banking regulation, but also taxes, high documentation requirements, lack of legal uniformity, and weak overall legal environment. SME-specific factors, i.e. factors intrinsic to their nature, are evaluated as very important obstacle by 10 per cent of the banks and important by 70 per cent of the banks. It is obvious that the banks find SMEs harder to deal with in comparison to other clients, which could be connected to high risks and lack of information which characterize SMEs. The fourth important obstacle concerns macroeconomic factors. The banks in BH feel the consequences of overall macroeconomic instability and imbalance, which affects them on the side of financing sources and on the side of lending as well. The obstacles given the lowest importance are lending technology to SMEs, lack of adequate demand, and bank-specific factors, which are considered unimportant by most of the banks.

When asked about possible areas in which government action could help enhance banks' incentives to increase SME lending, the banks provided similar answers. These responses could be summarized as follows:

- tax policy,
- interest rate subventions,
- dispute settlement,
- administrative procedures,
- legal uniformity,
- liquidity, and
- SME environment.

Tax reforms in the form of tax reliefs and lower tax burden for SMEs could have a positive effect on SMEs business and thus enhance demand for banks' services. Interest rate subventions would lead to a decrease in financing costs for SMEs, keeping banks' profit at the same level at the same time. Of course, government should finance only the interest rates for loans directed to production, development, and new job creation. Slow dispute settlement process burdens regular business activities for banks and also for SMEs, which is why banks suggest improvement of

judiciary. Complicated administrative procedures should be simplified through reducing the quantity of documentation as well as the time for its gathering. Because of a complex inner structure of BH, from municipalities, through cantons, entities to state level, there is a problem of different regulations. That is why banks suggest the unifying of regulations at the state level and deeper communication between institutions, which would facilitate banks and SMEs' business activities. A significant problem in BH is illiquidity of companies, which affects their creditworthiness. That is why government should make some steps towards solving this problem, for example with strong regulation on collection of receivables. General liquidity of BH economy could be improved by decreasing the reserve requirement for commercial banks. At the end, fostering SME environment implies developing strong overall business environment, increasing support and investment in SME sector, stimulating production, encouraging start-ups, and protecting domestic production.

Some banks also suggested measures which could be applied on a micro level, such as improving and simplifying the necessary documentation for opening bank accounts and loans, accepting weaker collaterals, focusing more on production companies, analytically considering client's needs, and offering appropriate types of loans. There is a need for partner relationship between bank and SMEs, with bank helping its client to use the best products/services to meet the needs, and client being fair and stable.

Conclusions and Recommendations

Using evidence from BH, this paper investigates a degree of SME banking development with the emphasis on drivers and obstacles to banks involvement with SMEs clients. One of the main findings of this research is that the SMEs sector is becoming a strategic sector for banks. This trend is observed in both, developed and developing countries around the world, as reported in the reviewed literature.

According to the data provided by the banks in BH, the ratio of SME loans to total corporate loans (which can be considered as the most important indicator of banks' involvement with SMEs) ranges from 7 to 85 per cent, with the average of 38 per cent. Besides granting loans, banks offer a wide spectrum of different financial services to SMEs clients that will compensate the higher risks of the segment.

All the banks surveyed stressed out the intention to increase their involvement in the SME sector in the future. Also, the banks which are subsidiaries of foreign banks and bank groups declared that their “parent” banks encourage SME financing.

Regarding obstacles to further development of banks’ involvements with SMEs, the surveyed banks identified intense competition amongst banks for SME clients. Besides that, regulation of the banking sector as well as tax regulation of SMEs is seen as a highly important limiting factor for increasing banks’ lending activities to SME clients.

Furthermore, the surveyed banks identified several areas of government actions which can be undertaken to strengthen the relationship between the financial sector and SMEs. The first action is related to comprehensive tax reforms aiming at lowering tax burden for SMEs in order to boost SME development, which will increase the need for banks to foster that development. The second action is related to the creation of stable funds for interest rate subventions to SMEs, while the third action is related to improvement of judiciary in terms of simplifying administrative procedures and reducing the number of necessary documentation for starting and maintaining a business. Fostering SME environment implies developing strong overall business environment, increasing support and investment in the SME sector, stimulating production, encouraging start-ups, and protecting domestic production.

At the end, banks suggested measures which could be applied on a micro level (*e.g.* improving and simplifying the necessary documentation for opening bank accounts and loans, accepting weaker collaterals, focusing more on production companies, *etc.*). There is a need for partnership between bank and SMEs, with bank helping its client to use the best products/services to meet the needs, and client being fair and stable.

As the survey shows, regardless of the fact that SMEs are a risky client segment, banks are willing to increase their involvement with SME clients. This finding is important in terms of further development and strengthening of the SME sector which is a key developing force of BH and other developing economies.

Based on the survey data regarding obstacles faced by the banks involved with SME sector, several concrete actions to foster relations with SME clients on the banks side can be undertaken.

First of all, in order to stay competitive in their demand of different financial products/services to SME clients, banks need to better understand the requirements of SME clients. This can be undertaken by surveying both existing and potential clients. More personal approach needs to be introduced when doing business with this client segments, meaning that banks products should be more customized to the need of each particular client. SME clients need to see banks as partners who are ready to offer not just financial source for financing their needs, but also financial advice.

Secondly, in order to address issues of inadequate regulation posed to SME clients, banks need to engage in lobbying the government bodies to change regulations governing SME sector. In that respect, the Banking Agency of the Federation of BH and of Republic of Srpska as the state supervisory bodies for banks, together with banks should start initiatives to change laws on taxation of SMEs. The following systematic measures in taxation of SMEs that should be considered and are proven in the EU taxation practices (EC, 2008), to strengthen SMEs capital (and, therefore, to decrease the riskiness of SME clients for banks):

- Deferral of corporate income tax. In other words, corporate income tax should be paid when profit is not retained in the companies, on the portion of profit paid to the owners.
- Allowance for corporate equity (ACE). This incentive is the only tax measure that takes the investment in own equity into consideration. Corporate tax systems discriminate in favour of debt financing since they allow the deduction of interest, but do not take into account the cost of capital in the form of equity financing. This discrimination, commonly known as the “interest tax shield”, encourages debt financing since it lowers the relative cost of debt. The ACE increases the attraction of investment and neutralises tax competition as far as own equity is concerned. It attracts investments because the investment in own equity is compensated regardless of risk.
- Reduction of tax rate for SMEs for the portion of retained earnings.

From banks' perspective, SMEs have access to external financial resources in the form of bank loans of different maturities. The next research question resulted from this research is related to the level of bank financial resources available for SMEs. In that respect, further research will be focused on investigating possible obstacles for SMEs to use banks' financial sources and other financial services as well as identifying necessary steps and activities to bring together SME clients and banks to an efficient and profitable cooperation between these two sectors.

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